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Hot Topics: Liabilities

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AASB Occasional Paper (OP) – a recap

- Definition
  - Liabilities defined ‘broadly’
  - Definition symmetrical with asset definition
  - Definition does not contain a threshold relating to existence uncertainty

AASB Occasional Paper – a recap

- Recognition criteria
  - No separate recognition criteria
    - Outcome uncertainty dealt with in measurement
    - Relevance ‘trumps’ reliability, i.e. select the most representationally faithful measure

AASB Occasional Paper – a recap

- Measurement
  - At initial recognition: measure all liabilities at fair value or another current value
  - Subsequently: measure most liabilities at current value

IASB Discussion Paper (DP) - tentative liability definition

- *“A liability is a present obligation of the entity to transfer an economic resource as a result of past events”*

- ‘Present obligation’ encompasses legal and constructive obligations

AASB Occasional Paper - liability definition

- *“A liability of an entity is a present economic burden for which the entity is obligated”*
- “A *‘present economic burden’* exists when an event has occurred that could require the transfer of economic resources from the entity to another party who will either benefit from the transfer of resources or suffer from the entity’s failure to transfer the resources”
- “An entity is *‘obligated’* in relation to an economic burden when there is either a mechanism to enforce the burden against the entity or the entity’s discretion to avoid the economic burden has effectively been removed, either through its own actions or otherwise”

Comparing and contrasting the definitions

- Similarities
  - – Not limited to legally enforceable obligations
    - But how wide is the notion of constructive obligation?
  - – Exclude threshold relating to existence uncertainty

Comparing and contrasting the definitions

- Differences
  - Reference to ‘past events’
    - **DP** includes specific reference to ‘past events’
    - **OP** contends that use of the prefix ‘present’ makes reference to ‘past events’ redundant

Comparing and contrasting the definitions

- Differences
  - Identifying the liability
    - **DP** – 'a liability is a present obligation'
    - **OP** – 'a liability is an economic burden' (as an asset is an economic resource)
    - **OP** - the economic burden is linked to an entity if the entity is obligated in respect of it
      - – likewise an economic resource is linked to an entity if the entity controls it (or if it has a right or other access to it)

Comparing and contrasting the definitions

- Litigation liabilities
  - **OP**: a liability exists, conceptually, when an entity breaches the law (rather than, for example, when the breach is detected, or when litigation is commenced, etc)
    - thus, a liability arises at the point of sale when an entity has a legal duty to provide goods or services that are fit for sale – the entity has an unconditional obligation to stand ready to compensate customers who subsequently suffer injuries
  - **DP**: it is not clear when, conceptually, a liability is considered to exist

Applying the OP definition to future events scenarios

	Scenario	Present obligation?		Reason	
		DP	OP	DP	OP
1	Employee bonus with vesting conditions	Yes, depending on circumstances	Yes, depending on the circumstances	The bonus is payable in exchange for, and measured by reference to, service received from employees. The employer has received two years' service at the reporting date. The employer can avoid paying the bonus only by terminating the employment contracts of all eligible employees before the end of the vesting period. It might argue that it has no practical ability to do so. The present obligation would be for the portion of the total expected bonus attributable to the benefits already received, ie the first two years of service.	• An economic burden exists – a transaction has occurred between the entity and its employees that could require the transfer of resources • An entity would normally be obligated in relation to the economic burden because its discretion to avoid the economic burden would have effectively been removed, ie a legal or constructive obligation would exist • A liability in respect of service received would exist from the date of the transaction

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Applying the OP definition to future events scenarios

	Scenario	Present obligation?		Reason	
		DP	OP	DP	OP
2	Levy on revenues above a threshold	Yes, in most circumstances	No	The rail operator has started to receive the benefits (earn the revenue) by reference to which the levy will be measured. The rail operator would need to curtail its operations significantly to avoid the levy. In most circumstances, it will not have the practical ability to take such action to avoid a levy.	• An economic burden exists – the government has introduced a levy that could require the transfer of resources • The entity is not (legally or constructively) obligated in respect of the economic burden until the threshold is met. Before the threshold is reached, the entity can curtail or discontinue its operations. • A liability does not exist at the reporting date. Similarly , the government does not have an asset at the reporting date because it does not control an economic resource at that date

Applying the OP definition to future events scenarios

	Scenario	Present obligation?		Reason	
		DP	**OP**	**DP**	**OP**
3	Levy on revenues	Yes, in most circumstances	No	The electricity supplier has received the benefits (revenues) on which the levy will be calculated. It could avoid the levy only by leaving the market before 1 April of the following year. In most circumstances, it will not have the practical ability to leave the market before that date.	• An economic burden exists – the government has introduced a levy that could require the transfer of resources • The entity is not obligated in respect of the economic burden until it is supplying electricity in the market at the designated date. Prior to that date, the entity has the discretion to avoid the economic burden by leaving the market • A liability does not exist at the reporting date. Similarly, the government does not have an asset at the reporting date because it does not control an economic resource at that date

Applying the OP definition to future events scenarios

	Scenario	Present obligation?		Reason	
		DP	**OP**	**DP**	**OP**
4	Levy that accumulates over the reporting period	Yes, in most circumstances	No	The bank has operated in the period over which the levy accumulates. In most circumstances, it will not have the practical ability to stop operating as a bank before the end of its financial reporting period. (The portion of the levy that would be attributable to the first half year is 0.9 per cent of the bank's expected period-end liabilities.)	• An economic burden exists – the government has introduced a levy that could require the transfer of resources • The entity is not obligated in respect of the economic burden until it is operating as a bank at the end of its annual reporting period. Prior to that date, the entity has the discretion to avoid the economic burden by ceasing to operate as a bank • A liability does not exist at the interim reporting date. Similarly, the government does not have an asset at the reporting date as it does not control an economic resource at that date

Applying the OP definition to future events scenarios

	Scenario	Present obligation?		Reason	
		DP	OP	DP	OP
5	Levy on market share	No	No	There is no past event from which an obligation has arisen. The requirement to pay a levy will be measured by reference to only one activity, namely participation in the market in 20X4. The entity has not started this activity at the reporting date.	• An economic burden exists – the government has introduced a levy that could require the transfer of resources • The entity is not obligated in respect of the economic burden until it is operating in the market in 20x4 as a manufacturer of electronic equipment. Prior to that date, there is no mechanism to enforce the burden against the entity or effectively remove the entity's discretion to avoid the burden • A liability does not exist at the interim reporting date. Similarly, the government does not have an asset at that date because it does not control an economic resource

Applying the OP definition to future events scenarios

	Scenario	Present obligation?		Reason	
		DP	OP	DP	OP
6	Variable lease payments	Yes, to the extent that the retailer does not have the practical ability to avoid future sales	Yes	The lessee has received a right-of-use asset in exchange for which it will have to pay the lessor 1 per cent of sales it makes during the lease period. In many circumstances, it will not have the practical ability to avoid making any sales.	• An economic burden exists – the entity has entered into a transaction with the lessor that could require the transfer of resources • The entity is legally obligated in respect of the economic burden because it is required under the terms of the contractual arrangement to transfer resources to the lessor if and when it generates sales • A liability exists at the date of the transaction and should be measured using a basis that captures the outcome uncertainty. Similarly, the lessor has an asset at the date of the transaction because an economic resource exists (resources may be transferred to the lessor) and that resource is controlled by the lessor via the contractual right arising under the lease agreement

Applying the OP definition to future events scenarios

	Scenario	Present obligation?		Reason	
		DP	OP	DP	OP
7	Contingent consideration	Maybe, depending on the circumstances	Yes	The acquirer has received the acquired business, in exchange for which it will have to pay CU5 million if the business meets earnings targets. The managers of the acquired business would have to take steps to reduce earnings below the target to avoid the payment. Whether they can do so might depend on the facts and circumstances.	• An economic burden exists – the entity has entered into a transaction with the vendor that could require the transfer of resources • The entity is legally obligated in respect of the economic burden because it is required under the terms of the contract of sale to transfer resources to the vendor if and when it meets the specified earnings targets • A liability exists at the date of the acquisition transaction and should be measured using a basis that captures the outcome uncertainty Similarly, the vendor has an asset at the date of the transaction because an economic resource exists (resources may be transferred by the purchaser) and the resource is controlled by the vendor via the contractual right arising under the sale agreement

Recognition

- Similarity
  - **DP** and **OP** both exclude any threshold relating to outcome uncertainty
- Differences
  - **DP** retains recognition criterion relating to faithful representation
  - **DP** includes recognition criteria relating to relevance and ‘cost/benefit’

Recognition

- **OP** contends that if a liability is considered to exist, information about that liability will be relevant to users and therefore recognition of the liability is necessary to meet the objective of financial reporting

- **OP** contends further that faithful representation should not be a barrier to liability recognition but should regulate the selection of the appropriate measurement basis – i.e. an iterative process should be followed using alternative measures until information that is relevant and representationally faithful is identified

- As for the cost constraint, it is pervasive and IASB specific. It is therefore unnecessary and perhaps inappropriate to include it as a specific recognition criterion

Measurement

- Measurement basis

  - **OP** focuses on identifying a measurement basis (or bases) that best reflects a liability's economic characteristics – and contends that this is necessary in order to meet the objective of financial reporting

  - **DP** contends that the nature of a liability and the way it will be settled are important in identifying an appropriate measurement basis, however it refrains from identifying the most appropriate basis or bases of measurement

Measurement

- Own credit risk
  - **OP** contends that own credit risk, being an economic characteristic of a liability, is a component of all current value measurements
  - **DP** acknowledges that own credit risk is incorporated into the pricing of every liability for which there is a transaction price, so credit risk will be automatically incorporated into the initial measure of those liabilities if they are measured at transaction price
  - However, the **DP** is unclear about whether an entity specific current measure of a liability includes own credit risk

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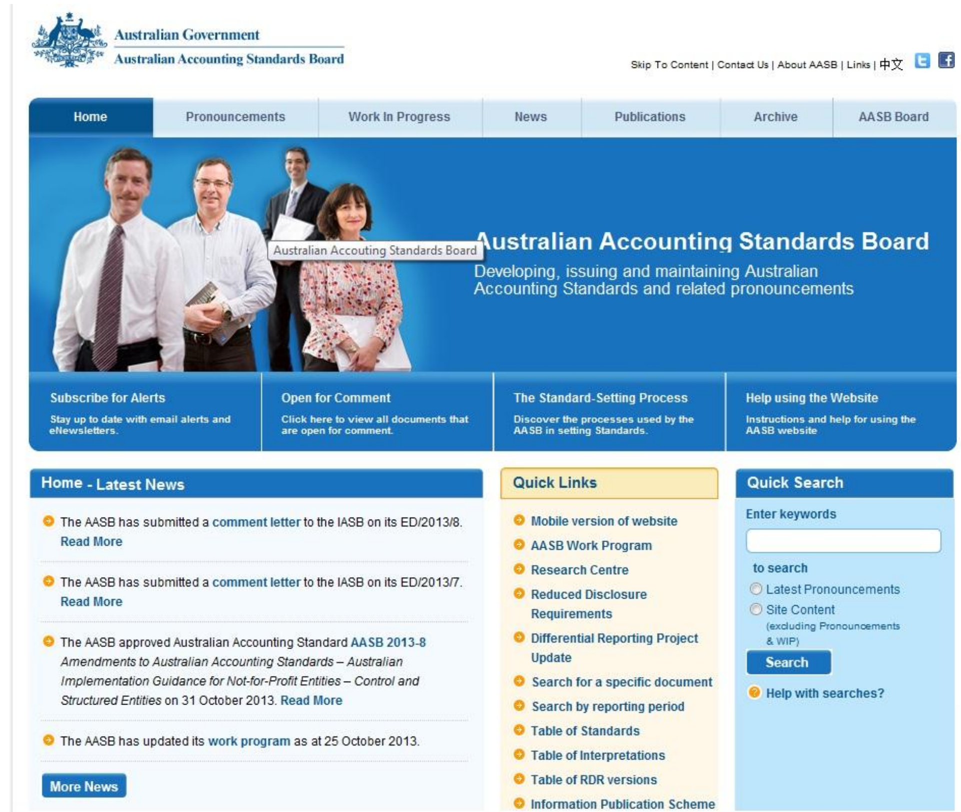

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